

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF TENNESSEE
Southern Division

In re

DOROTHY JEAN PALMER

Debtor

Bankruptcy Case
No. 91-14248

RICHARD P. JAHN, JR.,
Trustee in Bankruptcy

Plaintiff

Adversary Proceeding
No. 91-1129

v.

JERRY B. PALMER & FIRST
TENNESSEE BANK, N.A.,

Defendants

MEMORANDUM

Appearances: Jerry W. Weeks, Jahn, Jahn, Cavett, Maddux & Weeks,
Chattanooga, Tennessee, Attorney for Plaintiff

Mark T. Young, Mark T. Young & Associates,
Chattanooga, Tennessee, Attorney for Jerry B.
Palmer

Thomas L. N. Knight, Grisham & Knight, Chattanooga,
Tennessee, Attorney for First Tennessee Bank

R. Thomas Stinnett, United States Bankruptcy Judge

Dorothy Jean Palmer filed a chapter 13 bankruptcy case shortly after her divorce from Jerry L. Palmer. The divorce court adopted and incorporated into the final decree a property settlement agreement worked out by Mr. and Mrs. Palmer. The bankruptcy trustee in Mrs. Palmer's bankruptcy case brought this suit to have the property settlement set aside as a fraudulent transfer. For the reasons hereinafter stated, this adversary proceeding will be dismissed.

The trustee does not allege that Mr. or Mrs. Palmer intended to defraud creditors. The trustee alleges constructive fraud: the property settlement had the effect of defrauding Mrs. Palmer's creditors because she transferred valuable property rights to Mr. Palmer without receiving "reasonably equivalent value" in return while she was insolvent. 11 U.S.C. § 548(a)(2)(A).

The trustee's complaint focuses on a 29 acre tract of land that the Palmers owned as tenants by the entirety before their divorce. The property settlement made Mr. Palmer the sole owner. The 29 acre tract is not subject to any mortgages and includes the house where the Palmers lived.

First Tennessee Bank apparently believed that it had a mortgage on a one acre lot that included the Palmers' house to secure loans to Mr. Palmer, but the mortgage does not describe any of the 29 acre tract. The mortgage describes an adjoining one acre lot that belonged to Mr. Palmer. The trustee sued First Tennessee Bank to determine the priority between his fraudulent transfer claim and any claim the bank might have to the 29 acre tract or a part of it that includes the house.

The bank has filed a cross claim against Mr. Palmer to have the mortgage reformed to include the house. The cross claim also alleges that Mr. Palmer obtained the loan by fraud because he knew all along that the house was not on the one acre lot. Mr. Palmer has asked that the cross complaint be dismissed for lack of subject matter jurisdiction.

The one acre lot was deeded to Mr. Palmer only. The deed was recorded in 1975. The 29 acre tract was deeded to both Mr. and Mrs. Palmer in 1979. The 29 acre tract surrounds or almost surrounds the one acre lot. The lot and the 29 acre tract had been part of the one tract that belonged to Mr. Palmer's family. The one acre lot was carved out and transferred to Mr. Palmer and later on the 29 acre tract was transferred to Mr. and Mrs. Palmer.

In the late 1970's the Palmers built a house on the one acre lot. The house burned in 1983. The Palmers built a second house close enough to the location of the first that they could use the same well. The second house was about 50 feet away from the old foundation. This put the second house about 6 to 21 feet across the boundary and entirely on the 29 acre tract.

The Palmers thought that the house was on the one acre lot. The one acre lot was surveyed and stakes were put up to mark what was supposed to be the property line. The Palmers later on put a fence using the stakes as their guides. The new house was within the fence. Mr. Palmer marked the position of the fence on a copy of the survey done in October 1991. This shows the south side of the fence to the north of the true property line. Mr.

Palmer also erected a metal building that was supposed to be entirely on the 29 acre tract; however, it straddles the south line of the one acre lot. This is further evidence the Palmers believed the one acre lot was to the north of its actual location.

In 1987 Mr. Palmer applied for a home equity line of credit from First Tennessee Bank. Mr. Harbison handled the loan for the bank. He understood that the house was located on the one acre tract. The bank did not have a survey done. The bank did not require it at the time. The bank took the description of the one acre lot from an earlier mortgage that Mr. Palmer had given to the bank's predecessor, Hamilton National Bank. Furthermore, Mr. Harbison had been dealing with Mr. Palmer for many years. Mr. Palmer had always paid his debts to the bank. Mr. Harbison testified that the line of credit is the only debt Mr. Palmer has ever failed to pay the bank.

The bank did have the house appraised. The appraiser treated it as a house on a one acre lot. He found the market value to be \$110,000. The line of credit allowed Mr. Palmer to borrow up to \$88,000. Mr. Palmer used the line of credit to build a new house in Hamilton County and to buy farm equipment.

In 1988 Mr. Palmer bought 74 acres of mountain land at a tax sale. Apparently the deed was made to Mr. Palmer only. Mr. Palmer paid \$1,500 for the tax deed according to the sale report.

Mr. and Mrs. Palmer separated in January, 1991. At about the same time, Mrs. Palmer financed the purchase of a 1988 Ford Taurus.

Mrs. Palmer filed for divorce later in 1991. She was represented by an attorney, but Mr. Palmer was not. The Palmers entered into the property settlement as part of the divorce. The state court granted the divorce on August 5, 1991. The divorce decree found that the property settlement was an equitable settlement of the Palmers' property rights between them and incorporated the settlement by reference. Mr. Palmer was awarded custody of the parties' minor children consistent with the settlement agreement. Mrs. Palmer does not pay child support.

The property settlement divested Mrs. Palmer of any interest in the one acre tract and the 29 acre tract and made them Mr. Palmer's sole property. It made Mr. and Mrs. Palmer tenants in common in the 74 acre tract and provided that it would be sold and the proceeds divided evenly between them.

It awarded Mrs. Palmer the 1988 Ford Taurus and the household goods and furniture.

It awarded Mr. Palmer a 1988 Honda Accord, a 1977 Chevrolet van, a Chevrolet pick-up, and the farm equipment.

The property settlement made Mr. Palmer responsible for debts owed on the property awarded to him and provided that he would hold Mrs. Palmer harmless with regard to those debts. It made Mrs. Palmer responsible for debts owed on the property awarded to her and provided that she would hold Mr. Palmer harmless with regard to those debts.

At the trial Mr. Palmer estimated that the 29 acre tract would be worth \$600 to \$800 per acre without the house. He had no idea what the one acre lot is worth without the house.

Mrs. Palmer testified that she didn't know how much the house was worth at the time of the divorce. The statement of affairs filed in her bankruptcy case revealed the transfer of the house and 30 acres to Mr. Palmer. It stated \$75,000 as the value received for the transfer, but this may have meant the value of the property.

Mrs. Palmer's bankruptcy schedules valued her one-half interest in the 74 acres at \$10,000. The bankruptcy trustee testified that the property apparently does not exist. Exhibit 4, however, is the court order confirming the sale and includes a general description of the property.

Mrs. Palmer's bankruptcy schedules and her chapter 13 plan valued the 1988 Ford Taurus at \$5,300, which was less than the amount of the secured debt.

The property settlement awarded vehicles and farm equipment to Mr. Palmer that were paid for and not subject to any liens. He valued this property as follows:

1988 Honda	\$5,500
Chevrolet pick-up	600-800
Dump truck	2,500
Chevrolet van	600
1973 backhoe	3,000
Broken mower	100
Disc	800
<u>Turning plow</u>	<u>100</u>
TOTAL	\$13,200-13,400

The farm equipment also included a sprayer financed through Ford Motor Credit and a Case tractor that was subject to a security interest. Mr. Palmer sold the sprayer for enough to pay

the secured debt. He sold the Case tractor for about \$9,000 more than the secured debt.

Mr. Palmer owed about \$93,000 under the line of credit at the time of the divorce. The bank foreclosed its mortgage on September 10, 1991, slightly more than a month after the divorce. Until the foreclosure sale, the bank assumed that the house was on the one acre lot. A man asked the bank's representative at the foreclosure sale if she knew that there was not a house on the one acre lot. A lady who was a friend of Mr. Palmer's told her that there was no house on the lot. Mr. Skiles, the purchaser at foreclosure, asked her if there was a house on the lot, and she said there was. Mr. Skiles then talked to Mr. Palmer. Mr. Palmer testified that he first learned the house was not on the lot when Mr. Skiles had a survey done, which was apparently after the foreclosure. However, Mr. Skiles had told him before then that he thought the house was not on the one acre lot. The court is convinced that Mr. Palmer knew before the foreclosure sale that the house was not included within the description of the deed of trust given to the bank on the home equity line of credit, but failed to communicate this fact to the bank. He also knew the bank was relying upon the house as collateral for the loan.

The bank appraised the house and lot at \$70,000 for the purpose of foreclosure. The bank was warned at the foreclosure sale that the house was not on the one acre lot.

Mrs. Palmer filed a chapter 13 case a few days later—on September 13, 1991. She converted it to a chapter 7 liquidation in April, 1992, and the plaintiff was appointed bankruptcy trustee.

The record reveals that Mrs. Palmer's unpaid debts at the time of the divorce were almost entirely secured debts and that only Mrs. Palmer signed the notes, contracts, and security agreements. She owed secured debts to First Bank of Rhea County, Citizens Savings & Loan Association, Ford Motor Credit, Sovran Bank, and R & R Electronics. These secured debts were all incurred before the divorce and totaled about \$27,000. General Electric Capital filed a secured claim totaling about \$2,200. The proof of claim reveals that the debt was incurred before the divorce.

Mrs. Palmer scheduled a secured claim to First Tennessee Bank in the amount of \$80,000. First Tennessee filed an unsecured claim for about \$93,000. This was after it had foreclosed and learned that the house was not on the one acre lot covered by its mortgage. The copies of documents filed in this proceeding and the attachments to the proof of claim do not show Mrs. Palmer's signature on anything that would make her liable on the line of credit debt. She signed the deed of trust, but it specifically says that signing the deed of trust only makes the property liable for the debt; it does not make the signer personally liable. It may be that the copies inadvertently omitted Mrs. Palmer's signature or that the parties failed to file some other document that Mrs. Palmer signed to make her liable for the debt. Mrs. Palmer testified, however, that she didn't think she was liable to First Tennessee on the line of credit.

Mrs. Palmer scheduled unsecured debts totaled about \$3,200, all of which were incurred before the divorce. NationsBank

filed proof of another unsecured claim totaling about \$1,000 and dating from 1990.

Mr. Palmer called attorney John Meldorf as an expert witness. He testified to long years of practice in divorce cases in the Tennessee courts. He analyzed the property settlement and concluded that it was within the normal range that would be approved by a Tennessee court under the standards set by Tennessee law. His analysis assumed that the house was on the one acre lot instead of the 29 acre tract.

The trustee's fraudulent transfer suit has priority over the bank's right, if any, to have the mortgage reformed. *Epperson v. Robertson*, 91 Tenn. 407, 19 S.W. 230 (1892); see also 11 U.S.C. § 546.

The change of ownership rights made by a divorce decree fits within the Bankruptcy Code's broad definition of transfer. 11 U.S.C. § 101(54).

A divorce by itself cannot release either the husband or the wife from his or her debts. For example, the divorce decree may order the ex-husband to pay a debt jointly owed by him and his wife and to hold the ex-wife harmless. The ex-wife still owes the debt, and the creditor can collect directly from her. Indeed, the hold-harmless clause recognizes this. It makes the ex-husband liable to the ex-wife if she is forced to pay the debt. The property settlement did not affect Mrs. Palmer's debts. She owed the same debts afterward as before.

This means that the court must focus primarily on how the property settlement affected Mrs. Palmer's assets that were available to pay her creditors.

Mr. and Mrs. Palmer each received a one-half interest in the 74 acres, but there was no reliable valuation of these interests. They can be ignored for the moment as being equal in value in any event.

The property settlement would have divided the property more evenly if the house had been on the one acre lot. Mr. Palmer's equity was at most about \$17,000, the difference between the bank's highest appraisal (\$110,000) and the secured debt of about \$93,000. Assuming the house and one acre lot would have had this much equity, the property awarded to Mr. Palmer was worth \$56,600 to \$62,800, counting the equity only.

Only the equity can be counted in determining the effect on creditors for the purposes of § 548(a)(2).

Mrs. Palmer received household goods and furniture worth about \$25,000. The trustee's evidence did not rebut Mr. Palmer's testimony regarding the value of this property *at the time of the divorce*.

Thus, the property settlement apparently favored Mr. Palmer by about \$21,600 to \$37,800 even though Mrs. Palmer obtained the divorce and she was represented by a lawyer.

Mr. Meldorf testified that under Tennessee law this property division was within the normal range approved by Tennessee courts. The court suspects that the Palmers and the divorce court did not see the difference as this much. At the time of the

divorce, the bank was heading toward foreclosure on the house and lot. In light of this, the \$110,000 appraisal was probably irrelevant. The market value was probably somewhere between the bank's foreclosure appraisal of \$70,000 and loan appraisal of \$110,000. If it was half-way between, then there would have been no equity. The equity in the property awarded to Mr. Palmer would have been \$17,000 less.

If the property division had turned out either way, the court would hold that the property settlement was not a fraudulent transfer under § 548(a)(2). The court agrees with the bankruptcy court in New Hampshire that the use of § 548(a)(2) should be limited with regard to property divisions made by the state courts in divorce cases. *Harmon v. Sorluccho (In re Sorluccho)*, 68 B.R. 748 (Bankr. D. N. H. 1980) (Yacos, B.J.). The court said:

In my judgment Congress by use of the language "reasonably equivalent value" has provided sufficient flexibility for reconciling the different public policy purposes between the state and federal laws. I believe that the bankruptcy standard in this context should be interpreted to require only a "surface determination" by the bankruptcy court that the division of the marital property . . . was within the range of a likely distribution that would be ordered by the divorce court if the property division had actually been litigated I realize that the approach I take here is not supported by any existing case law. However, the alternative is for the bankruptcy court [to] become a court of "de novo divorce jurisdiction" to reexamine and redetermine the balancing of various . . . marital rights and interests in property—to determine whether what the nondebtor spouse "gave up" was equal to what that spouse received as a result of the divorce decree. I cannot believe that Congress intended the bankruptcy courts to have that overreaching, overarching function with regard to state courts in family law matters.

68 B.R. 753-754.

The use of § 548(a)(2) may be even more limited. *BFP v. Resolution Trust Corp.*, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994). In *BFP* the bankruptcy trustee attacked a foreclosure sale under § 548(a)(2) because the property sold for much less than its fair market value. The Supreme Court held that "reasonably equivalent value" does not mean "fair market value." As a result, the problem was determining the value of the foreclosed property. The court concluded that the value was the foreclosure sale price if the creditor followed all the requirements of state law.

The Supreme Court was greatly influenced by "400 years of peaceful coexistence" of fraudulent conveyance law and foreclosure law. 114 S.Ct. at 1764. The fraudulent conveyance laws had not been used to upset legally conducted foreclosure sales on the ground that the price was grossly inadequate. The court reasoned that Congress did not intend § 548 to be a weapon for attacking foreclosures carried out in accordance with state law.

The Supreme Court went on to say that a foreclosure sale may be set aside under § 548(a)(1) if the parties intended to hinder, delay, defraud creditors. Of course, if the husband and wife used the divorce with the intent to hinder, delay, or defraud his, her, or their creditors, the resulting property division can be set aside under § 548(a)(1). *Travelers Indemnity Co. v. Cormaney*, 138 N.W.2d 50 (Iowa 1965); *Wilkey v. Wax*, 225 N.E.2d 813 (Ill. App. 1967); *Kardynalski v. Fisher*, 482 N.E.2d 117 (Ill. App. 1985).

Likewise, a property settlement not approved by the divorce court may be subject to attack under § 548(a)(2). *Cf. BFP v. Resolution Trust Corp.*, 114 S.Ct. 1757, 1765 (1994).

The law in some states may allow a divorce decree or property settlement that was approved by the divorce court to be set aside as a constructive fraud on the creditors of one spouse. However, the legislature of the state can prevent this or regulate it. The same is true with regard to the bankruptcy trustee's rights under § 544 to the extent they depend on state law. See 11 U.S.C. § 544(a) & (b).

On the other hand, a state legislature cannot prevent the federal courts from applying § 548 of the Bankruptcy Code. This creates a situation in which federal law may impinge on a vital state interest, depending on how the federal courts determine the value of property transferred under the property settlement. The problem is essentially the same as it was in *BFP*, and the Supreme Court's reasoning applies. The court generally will defer to any property division that has been approved by the divorce court as an equitable division of the property. Otherwise, the bankruptcy courts will be assuming a supervisory power over the division of marital property in divorce cases. See *Barbee v. Pigott*, 507 So.2d 77 (Miss. 1987); *State Department of Commerce v. Lowery*, 333 So.2d 495 (Fla. App. 1976); *Mitchell v. Wilmington Trust Co.*, 449 A.2d 1055 (Del. Ch. 1982); see also *Glascok v. Citizens National Bank*, 553 S.W.2d 411 (Tex. Civ. App. 1977).

The court's reasoning applies with special force to the creditors who became creditors after the divorce. Section

548(a)(2) makes no distinction between debts owed at the time of the transfer and later debts. It treats any transfer for less than reasonably equivalent value as a reduction in the debtor's capital, a transfer that makes the debtor less able to pay future debts, and therefore a fraud on future creditors. Thus, a bankruptcy court could use § 548(a)(2) to undo the divorce court's equitable division of the property because a different equitable division would have left the spouse who later went bankrupt with more assets to pay future debts. *Smith v. AIFAM Enterprises, Inc.*, 737 P.2d 469 (Kan. 1987). This would be unwarranted interference by the bankruptcy courts with divorce matters that should be left to the state courts. (It appears that Mrs. Palmer's debts at the time of bankruptcy were all pre-divorce debts.)

The state court granted Mrs. Palmer the divorce on the ground of irreconcilable differences. In order to grant the divorce on that ground, the state was required to do two things. It had to find that Mr. and Mrs. Palmer had made an equitable settlement of property rights between them, and it had to include the property settlement in the decree or incorporate it by reference. TENN. CODE ANN. § 36-4-103(b). The divorce decree found that the property settlement was an equitable settlement of property rights between the Palmers and incorporated it by reference.

However, the state court's approval was based on the wrong assumption that the house was located on the one acre lot. This seems to have been the result of an honest mistake by the Palmers; they thought that the house was on the one acre lot when it was actually on the 29 acre tract. Since the 29 acre tract

included the house and was not subject to the bank's mortgage, it was worth much more than expected. Thus, Mr. Palmer apparently ended up with a greater equity in the 29 acre tract and the one acre lot than the state court expected. This led to the bankruptcy trustee's fraudulent transfer suit.

The question is whether the bankruptcy court should "correct" this mistake by avoiding the property settlement as a constructively fraudulent transfer. The court thinks not. There is no allegation of actual fraud. The settlement agreement was clearly within the range of reasonably equivalent values, particularly recognizing that Mrs. Palmer's creditors had no more than a claim against an expectancy in a tenancy by the entireties immediately before the divorce decree was entered. See *Carpenter v. Franklin*, 89 Tenn. 142, 14 S.W. 484 (1890); *Snodgrass v. Hyder*, 95 Tenn. 568, 32 S.W. 764 (1895); *Gurlich's, Inc. v. Myrick*, 54 Tenn.App. 97, 388 S.W.2d 353 (1964); *Robertson v. Wade*, 17 Tenn.App. 457, 68 S.W.2d 487 (1934).

First Tennessee Bank seems to have been the only joint creditor. It is certainly a creditor of Mr. Palmer. The result is that the transfer of the 29 acre tract to Mr. Palmer as sole owner did not put it beyond the reach of First Tennessee or any other joint creditor of Mr. and Mrs. Palmer.

Conclusion

The court's decision ends the trustee's claims and leaves only the bank's cross claim against Mr. Palmer for fraud and to reform the mortgage. Since the outcome of that dispute cannot

affect the bankruptcy case, the court will abstain even if the court has jurisdiction. *Alix v. Suitt Construction Co.*, 142 B.R. 807 (Bankr. S. D. Ohio 1992); *Ng v. Pacheco (In re Chong)*, 12 B.R. 255 (Bankr. D. Hawaii 1981).

At Chattanooga, Tennessee.

BY THE COURT

**R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE**

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF TENNESSEE
Southern Division

In re

DOROTHY JEAN PALMER

Debtor

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RICHARD P. JAHN, JR.,
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Plaintiff

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v.

JERRY B. PALMER & FIRST
TENNESSEE BANK, N.A.,

Defendants

ORDER

For the reasons stated in a Memorandum Opinion filed
contemporaneously herewith,

It is ORDERED that the adversary proceeding is dismissed;
and

It is further ORDERED that the cross claim of First
Tennessee Bank, N.A., against Jerry P. Palmer is dismissed without
prejudice.

ENTER:

BY THE COURT

R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

[entered January 13, 1995]